

CHAPTER 1

Accounting Principles & Practices

An Overview

Definition:

Accounting is the process of *identifying, measuring, recording, summarizing, reporting/communicating/ & interpreting* the **Business Transactions** to different users for decision making purposes.

Accounting is defined as the process of identifying, measuring, recording, classifying, summarizing, analyzing and interpreting economic events (financial transactions) and communicating the results thereof to the entities interested in such information to enable them make informed judgments. The analysis the definition is as follows:

Identifying- to distinguish an event or a transaction that must be recorded.

Measuring- quantifying an event or a transaction i.e. accounting deals with only those transactions and events that can be expressed in terms of money.

Recording- this is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner.

Classifying- it is concerned with the systematic analysis of the recorded data with a view to group transactions or entries of one nature at one place.

Summarizing- this involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end users of accounting statements or other accounting information

Analyzing- means methodical classification of the data given in the financial statements. For example, all items relating to “current assets” are put at one place.

Interpreting- explaining the meaning and significance of the data so simplified and analyzed

Communicating- the accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner to the proper person.

Accounting: The Language of Business

What is the role of accounting in business is that accounting provides information for managers to use in operating the business? In addition, accounting provides information to other users in assessing the economic performance and condition of the business. Thus, accounting can be defined as an information system that provides reports to users about the economic activities and condition of a business. Accounting is called as the “**language of business.**”

This is because accounting is the means by which businesses’ financial information is communicated to users.

Business Transactions are the financial occurrences of an event that must be recorded in the accounting records. As businesses & society have become complex over years, accounting has developed new concepts & techniques to meet the ever-increasing needs for financial information. Without such information, many complex economic developments social programs might never be undertaken.

Users of Accounting Information:

1. External Users: Any user outside that entity.

INVESTORS: need the accounting information to know the financial status of the organization to make a decision whether to invest their capital in the entity.

BANKERS/LENDERS/ & SUPPLIERS: appraise the financial of soundness a business organization & assess the risks involved just before they make a loan & grant credits.

GOVERNMENT AGENCIES: are concerned with the financial activities of a business organization for taxation purposes & regulations.

EMPLOYEES & LABOR UNION: are also interested in the stability & profitability of the business organization that hires them in negotiating labor contract.

2. Internal Users: the user with in the entities, example employee and managers.

THE MANAGEMENT: these are the responsible people for directing the operation of enterprises, demand the accounting information to accelerate favorable trends & to reduce those unfavorable, to evaluate the employees' current performance & appraise them accordingly, to plan the future.

Classification of Business Organizations

A **business** is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. The objective of most businesses is to earn a profit.

Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services.

Types of businesses (Based on their operation): Three types of businesses operated for profit include service, merchandising, and manufacturing businesses.

1. Service businesses provide services rather than products to customers. E.g: Ethiopian Air Lines (transportation services), Edna Mall (entertainment services)

2. Merchandising businesses sell products they purchase from other businesses to customers. E.g: Showa Super market (general merchandise), Belayab Trading (Trucks merchandise)

3. Manufacturing businesses change basic inputs into products that are sold to customers. E.g: General Motors Corporation (cars, trucks, vans), Dell Inc. (personal computers)

Types of business organizations (based on formation): The three types of businesses (service, merchandising, and Manufacturing) may be organized as proprietorships, partnerships, corporations, or limited liability companies. Business organizations are classified as follows based on their forms:-

Sole proprietorship: These firms are owned by one person, usually the individual who has day-to-day responsibility for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume "complete personal" responsibility for all of its liabilities or debts. In the eyes of the law, you are one in the same with the business.

Partnership: In a Partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The Partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, or what steps will be taken to dissolve the partnership when needed. They also must decide up front how much time and capital each will contribute, etc.

Corporation: A Corporation, chartered by the state in which it is headquartered, is considered by law to be a unique entity, separate and apart from those who own it. A Corporation can be taxed; it can be sued; it can enter into contractual agreements. The owners of a corporation are its shareholders. The shareholders elect a board of directors to oversee the major policies and decisions. The corporation has a life of its own and does not dissolve when ownership changes.

Limited liability Company (LLC): combines the attributes of a partnership and a corporation. Often used as an alternative to a partnership. It has tax and legal liability advantages for owners.

Accounting Equation

Assets: A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Equity: the right/claim of the owner against the properties

Example: XYZ Company acquired an automobile of \$100,000

Asset = Equity	100,000 = 100,000
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Equity may be categorized to two broad principal subdivisions as:

1. The right of the creditors/ Liabilities
2. The right of the owner/ owner's equity

Liabilities A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. So we can say that:

Asset = Liabilities + Owner's Equity

Further consider the above example that \$45,000 of the total amount is borrowed from someone else to purchase an automobile & remaining is contributed by the business itself. So we can it in accounting equation as:

Asset = Liability + Owner's Equity	\$45,000 + \$55,000
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Key Terms

Accounts Payable: a liability that is created from purchase on account and/or raising funds through loan

Prepaid Expenses: purchase of consumable goods or advance a\cash payment for unused services

Revenues: income generated from sales of goods & services

Accounts Receivable: claim of the business organization against the customer that is created as a result of sales on account or performing a certain services at not for cash.

Expenses: Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. Note connection with assets and liabilities.

Analyzing Transactions

Business Transaction is the occurrence of an economic event that affects the financial position of a business. A particular business transaction may lead to an event or condition that result in another transaction. For example, purchase of car on credit will be followed by payment to the creditor, which is another transaction. The wearing-out of car is not an exchange of goods or services between the business and an outsider, but it has to be recorded. This type of transaction, as well as others that are not directly related to outsiders, referred as **internal transaction**.

Assume that Mr. John established a Sole Proprietorship to be known as Long Taxi, and completed the following transactions during the month of August:

August 1: Mr. John deposited \$10,000 at bank in the name of his business

5: Mr. John purchased land for future building site, \$7,500 for cash
 8: Mr. John purchased gasoline, oil & other supplies agreeing to pay the amount on the near future, \$850
 12: The business earned fares of \$4,500 & received the amount for cash
 18: Paid creditors on account for purchase of August 8, \$400
 27: Long taxi incurred & paid the following expenses for the month of August: wages expense = \$1,125, rent expense = \$850, utilities expense = \$150 & miscellaneous expense = \$75
 30: Withdrew \$1,000 for personal use
 31: determined the cost of supplies on hand to be \$250. Supplies of \$600 have been used in the operation

August	Assets			Liabilities	Owner's Equity	Description
	Cash		Land	A/P	John, Capital	
1	+ 10,000				+ 10,000	Investment
5	(7,500)		+ 7,500			
8		+ 850		+850		
12	+ 4,500				+ 4,500	Fares earned
18	(400)			(400)		
27	(2,200)				(1,125)	Wages expense
					(850)	Rent expense
					(150)	Utilities expense
					(75)	Misc. expense
30	(1000)				(1000)	Withdrawal
31		(600)			(600)	Supplies expense
	<u>\$3,400</u>	<u>\$25 0</u>	<u>\$7,500</u>	<u>\$450</u>	<u>\$10,700</u>	

Note: The effect of every transaction I stated in terms of increase and/or decrease in one or more accounting equation elements. The equality of the two sides is **always** maintained; & the owner's equity increases by additional investment & revenues and decreases by expenses & withdrawals.

Financial Statements for Sole proprietorship

There are four principal financial statements namely ***Income Statement, Statement of Owner's Equity, Statements of financial position & Statement of Cash flows.***

Income Statement: is the summary of all revenues & expenses for the **specific period** such as a month, a quarter, a semi annual, and a year. The excess of the revenue over the expenses incurred to earn the revenues is called Net Income or profit, whereas the excess of expenses over revenues are said to be Net Loss.

Statement of Owner's Equity: the summary of the changes in the owner's equity that have occurred during the specific period such as a year. Owner's equity is affected by additional investment, revenues, expenses & withdrawals.

Statements of financial position: is the list of assets, liabilities & owner's equity as of a specific date, usually at the close of the last date of month or the year. The preparation of the balance sheets takes either a report form or account/equation form.

Statement of Cash flows: the summary of cash receipts & payments of a business entity for specific period such as a year. It is customary to report cash flows in three sections:

- a. Cash Flows from operating activities: includes cash transactions that enter into the determination of the net income.
- b. Cash Flows from investing activities: the section reports the cash transaction for the acquisition & sale of relatively permanent assets such as land, equipment, building...
- c. Cash Flows from financing activities: this section reports the cash transaction related to cash investment by the owner & borrowed funds, and cash withdrawn by the owner for personal use.

Note: the preparation of all financial statements is identified by the name of the business, the title of the financial statement & the date/period of preparation. The use of indentions, captions, dollar signs & rulings are much more necessary because they aid the reader by emphasizing the various distinct sections of the statement. Below are the financial statements of Long Taxi.

Long Taxi
Income Statement
For the month ended, August 31, 2009

Revenues:		
Fares Earned		\$4,500
Expenses:		
Wages expense	\$1,125	
Rent expense	850	
Supplies expense	600	
Utilities expense	150	
Miscellaneous expense	<u>75</u>	
Total expense		<u>(2,800)</u>
Net Income		<u>\$1,700</u>

Long Taxi
Statement of Owner's Equity
For the month ended, August 31, 2009

Mr. John, Capital as of August 1, 2009		\$ 0
Beginning investment	\$10,000	
Add: Net Income	1,700	
Less: Withdrawal	<u>(1000)</u>	
Increase in owner's equity		<u>10,700</u>
Mr. John, Capital as of August 31, 2009		<u>\$10,700</u>

The sequential order of the Net Income & Withdrawal will be reversed if withdrawal exceeds the net income; and said to be decrease in owner's equity, the difference will then be deducted from the beginning capital.

Long Taxi
Balance Sheet
August 31, 2009

✓ Assets	
Cash	\$3,400
Supplies	250
Land	<u>7,500</u>
Total assets	<u>\$11,150</u>
✓ Liabilities	
Accounts Payable	\$450
✓ Owners Equity	
John, Capital	
Total Liabilities & Owner's Equity	\$10,700
	<u>\$11,150</u>

Long Taxi
Statement of Cash Flows
For the month ended, August 31, 2009

✓ Cash Flows from operating activities:		
Cash received from customers	\$4,500	
Less: cash payments for expenses & to creditors	<u>(2,600)</u>	
Net cash flow from operating activities		\$1,900
✓ Cash flows from investing activities:		
Less: cash payments for acquisition of land		(7,500)
✓ Cash flows from financing activities:		
Cash received from owner as investment	\$10,000	
Less: Withdrawal	<u>(1,000)</u>	
Net cash flow from financing activities		<u>9,000</u>
✓ Net cash flow		<u>\$3,400</u>

Activity

Enmesh Business Center, which is owned Mr. Erik, at the beginning of Year 2009, has the following beginning balance accounts:

Cash= \$25,000, Accounts Receivable= \$8,000, Supplies= \$7,500, Building= \$150,000 & Accounts= \$32000

Enmesh Business Center completed the following transactions since January, 2009:

January 1. Mr. Erik invested additional cash of \$10,000 in the business

2. Purchased equipments \$5,000 on account
5. Performed service for cash \$5,200
9. Billed customers for fees earned \$2,000
13. paid suppliers on account \$ 3,200
16. Received customers on account \$5,200
21. Purchased supplies \$800 paying a half amount
24. Paid telephone, power & water expense \$750
29. Determined supplies used in the operation process \$2,300
30. Paid salary expense \$800, trucks expense \$650, & rent expense \$980
30. Withdrew\$1,750 for personal use
31. Paid miscellaneous expense of \$320

Instruction:

- *Analyze these transactions*
- *Prepare the four principal financial statements for the month of January, 2009*

The analyses of transactions completed by Enmesh Business Center during the Month of January are presented as follows:

January	<u>Assets</u>					<u>Liability</u>	<u>Owner`s Equity</u>	Description
	Cash	A/ R	Supplies	Equipment	Building	A/P	Capital	
	\$25,000	\$8,000	\$7,500		\$150,000	\$32,000	\$158,500	Beginning Balance
1	+ 10,000						+ 10,000	Additional Investment
2				+ \$5,000		+ 5,000		
5	+ 5,200						+ 5,200	service fees
9		+ 2,000					+ 2,000	fees earned
13	(3,200)					(3,200)		
16	+ 5,200	(5,200)						
21	(400)		+ 800			+ 400		
24	(750)						(750)	utilities expense
29			(2,300)				(2,300)	supplies expense
30	(2,430)						(980)	rent expense
							(800)	salary expense
							(650)	trucks expense
30	(1,750)						(1,750)	withdrawal
31	<u>(320)</u>						<u>(320)</u>	misc. expense
	<u>\$36,550</u>	<u>\$4,800</u>	<u>\$6,000</u>	<u>\$5,000</u>	<u>\$150,000</u>	<u>\$34,200</u>	<u>\$168,150</u>	

The preparation of the four principal financial statements is presented below:

Enmesh Business Center

Income Statement

For the month ended, January 31, 2009

➤ Revenues:		
Service fees		
	\$5,200	
Fees earned		
	<u>2,000</u>	\$7,200
➤ Expenses:		
Supplies expense		
Rent expense	\$2,300	
Salary expense	980	
Utilities expense	800	
Trucks expense	750	

Miscellaneous expense	650	
Total expenses	<u>320</u>	
➤ Net Income		<u>(5,800)</u>
		<u>\$1,400</u>

Enmesh Business Center
Statement of Owner`s Equity
For the month ended, January 31, 2009

Erik, Capital as of January 1, 2009			\$23,500
Add: Additional Investment	\$10,000		
Net Income	<u>1,400</u>	\$11,400	
Less: withdrawal		<u>(1,750)</u>	
Increase in capital			<u>9,650</u>
Erik, Capital as of January 31, 2009			<u>\$33,150</u>

Enmesh Business Center
Balance Sheet
January 31, 2009

Assets	
Cash	\$36,550
Accounts Receivable	4,800
Supplies	5,800
Equipment	5,000
Building	<u>150,000</u>
Total Asset	<u>\$202,350</u>
Liabilities	
Accounts Payable	\$34,200
Owner`s Equity	
Erik, Capital	<u>32,950</u>
Total Liabilities & owner`s Equity	<u>\$168,150</u>

Enmesh Business Center
Statement of Cash Flows
For the month ended, January 31, 2009

➤ Cash flows from Operating Activities:		
Cash received from customers	\$10,400	
Less: Cash payments to creditors & suppliers	<u>(7,400)</u>	
Net cash flow from operating activities		\$3,300
➤ No Cash flows from Investing Activities		
➤ Cash flows from Financing Activities:		
Cash received from the owner		
Less: Cash withdrawn by the owner	\$10,000	
Net Cash from Financing Activities	<u>(1,750)</u>	
Add beginning cash balance		8,250
✓ Net Cash flow		<u>25,000</u>
		<u>\$36,550</u>